

Message Text

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ACTION EB-11

INFO OCT-01 EUR-25 EA-11 ADP-00 AID-20 CEA-02 CIAE-00

COME-00 FRB-02 INR-10 IO-13 NEA-10 NSAE-00 RSC-01

OPIC-12 CIEP-02 LAB-06 SIL-01 OMB-01 XMB-07 AGR-20

STR-08 SS-15 NSC-10 L-03 H-03 PRS-01 PA-03 USIA-15

TAR-02 RSR-01 /216 W

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P R 271112Z JUL 73

FM AMEMBASSY LONDON

TO SECSTATE WASHDC PRIORITY 2913

INFO AMEMBASSY BONN

AMEMBASSY PARIS

AMEMBASSY ROME

AMEMBASSY TOKYO

USMISSION EC BRUSSELS

USMISSION OECD PARIS

TREASURY DEPT WASHDC PRIORITY

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DEPARTMENT ALSO PASS FRB

E.O. 11652: N/A

TAGS: EFIN, UK

SUBJECT: STERLING'S DOWNWARD SLIDE

REF: (A) LONDON 8421, (B) LONDON 8425 (C) LONDON A-924

BEGIN SUMMARY. STERLING CONTINUES MOVE DOWNWARD, NO
SINGLE FACTOR RESPONSIBLE. MARKET CITES INTEREST
RATE DIFFERENTIALS, POOR U.K. TRADE ACCOUNT, UNCERTAIN
CLIMATE FOR INDUSTRIAL RELATIONS AND OUTRIGHT
SPECULATION AS CAUSES. END SUMMARY.

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1. MARKET OPERATORS CLAIM NO SINGLE ELEMENT IS

CAUSING STERLING'S DECLINE. BANK OF ENGLAND'S EFFORTS LAST WEEK TO RAISE INTEREST RATES (REF A) HAVE NOT YET HAD EFFECT OF REESTABLISHING DIFFERENTIALS BETWEEN LONDON AND OTHER MARKETS, GIVEN INCREASED RATES ELSEWHERE. HIGH CALL MONEY RATES IN GERMANY CONSIDERED VERY DISTURBING ELEMENT. RATES ARE EXPECTED TO INCREASE TODAY IN LONDON.

2. ON JULY 26, STERLING FELL AGAINST DOLLAR TO \$2.4845, DOWN ALMOST TWO CENTS FROM WEDNESDAY AND 4.9 CENTS FROM LAST THURSDAY'S CLOSE (\$2.5340). THIS IS THE LOWEST RATE AGAINST DOLLAR SINCE MARCH, WITH FINANCIAL TIMES SHOWING WEIGHTED DEVALUATION OF 19.33 PERCENT IN SMOTHSONIAN RATES. INVESTMENT DOLLAR PREMIUM ALSO ROSE TO OVER 35 PERCENT (BASED ON \$2.60), UP FROM 32 PERCENT ON WEDNESDAY AND 28 PERCENT LAST THURSDAY. THE PREMIUM HAS BEEN INCREASING STEADILY IN RECENT WEEKS.

3. EMBASSY REPORTED LAST WEEK THAT THERE WAS GROWING MISTRUST OF STERLING, EVIDENCED BY RISING INVESTMENT DOLLAR PREMIUM AND LONDON AND CAMBRIDGE ECONOMIC BULLETIN FORECAST OF INCREASED TRADE AND CURRENT ACCOUNT DEFICIT IF BUDGETARY RESTRAINT NOT INTRODUCED (REF A). SOME OF POLITICAL BACKGROUND GIVEN IN REF B. SOME BUSINESS ECONOMISTS HAVE BEEN EXPECTING THAT STERLING WOULD DECLINE FURTHER, (REF C). STRONG DOMESTIC EXPANSION WITH DECLINING UNEMPLOYMENT AND REDUCED INDUSTRIAL SPARE CAPACITY RAISES THE QUESTION OF HOW LONG CURRENT RATE OF GROWTH IN RANGE 5 TO 6 PERCENT CAN BE CONTINUED. A KEY QUESTION IS WHAT MEASURES GOVERNMENT WILL BE WILLING TO INTRODUCE TO SLOW DOWN THE ECONOMY. BASED ON CHANCELLOR'S PAST STATEMENTS THAT U.K. WANTS TO AVOID STOP-GO POLICIES, MARKET WONDERS IF GOVERNMENT WILL TAKE MEASURES TO DEFEND THE EXCHANGE RATE AT THE EXPENSE OF THE ECONOMY. GOVERNMENT WILL HOLD DISCUSSIONS THIS WEEK AND IN COMING WEEKS WITH UNIONS AND CONFEDERATION OF BRITISH INDUSTRY ON PHASE III OF ANTI-INFLATION PROGRAM. OUTCOME OF THESE DISCUSSIONS REMAINS IN DOUBT.
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4. THE ABOVE CONSIDERATIONS HIGHLIGHT THE GENERAL UNCERTAINTY. SOME MARKET OPERATORS HAD BEEN EXPECTING REVERSAL LATER IN YEAR OF SIZABLE CAPITAL INFLOWS RECEIVED DURING FIRST QUARTER, MUCH OF WHICH REPORTEDLY HAS BEEN HELD IN STERLING ON AN UNCOVERED BASIS.

5. CURRENT SLIDE IN STERLING RATE WILL ALSO CAUSE

SOME REFLECTION WHEN UK AND EC OFFICIALS CONSIDER
POSSIBLE ENTRY OF POUND INTO THE SNAKE, ASKING
HYPOTHETICAL QUESTION WHAT WOULD HAVE HAPPENED THIS
WEEK HAD STERLING ALREADY BEEN IN THE SNAKE.

6. ALL THIS SAID, SOME FOREIGN EXCHANGE DEALERS SEE
LITTLE IMMEDIATE ECONOMIC JUSTIFICATION FOR STERLING'S
DOWNWARD SLIDE. LEAVING ASIDE THE LIRE, STERLING IS
VIEWED BY MOST AS THE WEAKEST OF EUROPE'S CURRENCIES.
WHEN THERE IS GENERAL UNCERTAINTY IN THE MARKETS, THE
REACTION IS TO SELL STERLING. CURRENTLY THERE IS A
THIN MARKET, WITH MANY SELLERS AND FEW BUYERS. BANK OF
ENGLAND HAS GIVEN SUPPORT, BUT SOME DEALERS BELIEVE
THAT THERE IS MORE NEED FOR CENTRAL BANK INTERVENTION
AND THAT STERLING AND OTHER CURRENCIES COULD BE
SUPPORTED AT REALISTIC RATES BY DIRTY FLOATING.
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